Internal Revenue Service

memorandum

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Br1:RACadenas

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to: Stephen M. Ehrlich, Chief Collection Branch CP: IN:D:C:C
Office of Assistant Commissioner (International)

from: George M. Sellinger, Chief Branch 1
Associate Chief Counsel (International) CC:INTL:

subject: [redacted]

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This is in response to your memorandum dated November 30, 1994, concerning the above taxpayer.

ISSUE

The issue presented is whether a sale of a principal residence in the U.S. occurring on May 15, 1987, by a nonresident alien may qualify for "rollover" treatment under I.R.C. § 1034, upon the taxpayer's purchase of another residence in a foreign country within 2 years.

FACTS

The taxpayer, [redacted] is currently [redacted], a West African country. During the years in issue he owned and resided in a single family residence in the Washington area, and he worked in a diplomatic position [redacted] at the [redacted] in Washington D.C. In [redacted] was considered a non-resident alien (NRA) for income tax purposes, and filed form 1040NR with the IRS where he reported the gain upon the sale of his U.S. residence on [redacted] and claimed a "rollover" (deferral) of such gain based on I.R.C. § 1034. Within 2 years of the [redacted] sale [redacted] purchased another residence in his home country of [redacted] for a cost in excess of the sales price of his previous U.S. residence.

[redacted] has maintained sufficient assets in a U.S. bank account to satisfy his [redacted] income tax liability attributable to this issue to the IRS, and the Collection Division has asked whether it should levy upon this account.

DISCUSSION

Under the temporary regulations, the taxpayer would not be entitled to claim deferral of gain under § 1034, with respect to the gain realized upon the sale of his residence in [redacted]. Treas. Reg. 1.897-6T(a)(5) provides as follows:

> (i) Purchase of a foreign principal residence. A nonresident alien individual shall not be entitled to nonrecognition under 1034 on the sale of a principal residence when the new principal residence acquired is not a U.S. real property interest.
>
> (ii) ***[1] A nonresident alien individual who sells his principal residence that is a U.S. real property interest **on or before June 6, 1988**, shall to the extent provided by section 1034, not recognize gain upon the sale of the principal residence if the new principal residence is a U.S. real property interest. [Emphasis supplied].

Treas. Reg. 1.897-6T(d) provides as follows:

> Effective date. Except as specifically provided in the text of the regulations, paragraphs (a) through (c) shall be effective for transfers, exchanges and other dispositions occurring after June 18, 1980. Paragraph (a)(5)(ii) shall be effective for exchanges or elections occurring after June 6, 1988. [T.D. 898, 5-4-88.]

Section 1.897-6T(a)(5)(i) would therefore apply sales of residences by NRAs dating back to June 18, 1980, under the general effective date rule in section 1.897-6T(d). The excerpted portion of section 1.897-6T(a)(5)(ii) (concerning pre-June 6, 1988 sales), would also apply back to June 18, 1980, because it is a carve-out that is "specifically provided in the text of the regulations."

Despite the application of the above regulation to the facts of the present case, the taxpayer's representative claims that the "retroactive effect" of the above regulation is unfair since it purports to impose a rule different than what applied at the time of the sale of the taxpayer's residence and when his [redacted] return was prepared and filed.

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[1]The first part of this provision concerns procedural rules (not applicable in this case) concerning NRAs who wish to claim §1034 treatment for sales of U.S. residences after June 6, 1988.

We believe that Treas. Reg. 1.897-6T(a)(5)(i) is properly applied to the circumstances of this case, and recommend that the taxpayer's argument regarding retroactivity be rejected. It was some seven years before the sale of the taxpayer's residence that the Foreign Investment in Real Property Tax Act of 1980[2] (FIRPTA) was enacted. Since 1980, nonresident aliens with real property investments in the U.S. were made aware of the fact that all such holdings may be subject to U.S. income tax.

FIRPTA added Code section 897(e)(1) which states that "[a]ny nonrecognition provision shall apply for purposes of this section to a transaction only in a case of an exchange of a United States Real Property Interest for an interest the sale of which would be subject to taxation under this Chapter." Subsection (e)(2) of the statute authorizes the Secretary to issue regulations in this regard.

Therefore, the fact that the deferral/rollover regime of I.R.C. § 1034 was limited by the temporary regulations to an NRA's re-investment in a principal residence that is a U.S. real property interest (USRPI) should not have come as a surprise to foreign investors and tax practitioners. The issues of tax-free exchanges and reorganizations under FIRPTA were the subject of considerable public debate in the international tax arena, during the period leading up to the enactment of the Temporary Regulations on May 4, 1988.

It may be argued that the taxpayer's argument of retroactivity is flawed because the denial of I.R.C. § 1034 rollover treatment in this case is mandated by the statute in force since 1980. Even if we give credence to the taxpayer's retroactivity argument, it should not be sustained in this case. Federal court decisions have discussed the standards applicable to similar regulations that have been applied retroactively. See Gehl Co. v. Commissioner, 795 F.2d 1324, 1332 n.9 (7th Cir. 1986), affg. in part T.C. Memo. 1984-667; Anderson, Clayton & Co. v. United States, 562 F.2d 972, 984 (5th Cir. 1977). Generally, the retroactive application of an income tax regulation has been reviewed for an abuse of discretion. Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 184 (1957). The retroactive application of Treas. Reg. 1.897-6T in this case is not an abuse of discretion because it accomplishes a result clearly embodied in the Congressional mandate as set forth in Code section 897(e)(1).

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[2]P.L. 96-499, 1980-2 C.B. 509.

Since the deficiency in tax has been assessed against the taxpayer for [redacted], this case is in a procedural status that justifies prompt collection action by the Service, without further need to review this matter. It is our understanding that your inquiry was prompted by correspondence and telephone calls from the taxpayer's representative requesting an administrative review of this matter, prior to collection or payment.

The taxpayer has foregone his best prepayment judicial remedy by not responding to the Statutory Notice of Deficiency (I.R.C. § 6212) and by not filing a petition in Tax Court. After payment of the [redacted] deficiency, the taxpayer may nonetheless file a claim for refund with the IRS, and if denied, he may bring an action in the U.S. District Court or the U.S. Court of Federal Claims where these issues may again be raised[3].

Please contact Rick Cadenas at 874-1490 if you wish to discuss this matter.

George M. Sellinger

[3] In the event this matter is raised in a claim for refund context, you may wish to review Rev. Rul. 71-494, 1972-2 C.B. 311 (which has to date not been revoked) that contains the following language contrary to the cited temporary regulations: "Section 1034 of the Code imposes no requirements as to citizenship, residency or location of the new residence." We may distinguish that ruling on the basis that its holding applied I.R.C. §1034 only to resident aliens, as opposed to nonresident aliens which is the status of the taxpayer in this case.